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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

Nos. 1301, 1302

FEDERAL POWER COMMISSION,

Petitioner

and

MEMPHIS LIGHT, GAS AND WATER DIVISION,

Petitioner

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPELINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION,

Respondents

On Petitions for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

JOINT BRIEF OF RESPONDENTS, TEXAS EASTERN TRANSMISSION CORPORATION AND NATURAL GAS PIPELINE COMPANY OF AMERICA, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

Texas Eastern Transmission Corporation (Texas Eastern) and Natural Gas Pipeline Company of America (Natural) respectfully request that this Court deny the Petitions for Writ of Certiorari filed herein, by each petitioner, for the reasons set forth herein below.

QUESTION PRESENTED.

Were the United States Courts of Appeals for the Fifth and Tenth Circuits in error when they each held[1] that the Federal Power Commission cannot lawfully reduce the rates of a natural gas company subject to the Commission's jurisdiction, through a "consolidated effective tax rate" device, when such rate reduction would be effected by utilizing, for that purpose, the losses for tax purposes suffered by other corporate entities in the corporate system, the operations of which other companies are separate from those of the jurisdictional company, when such other corporations and/or their loss operations are not subject to Commission jurisdiction and when the filing of a consolidated tax return, which includes both jurisdictional and nonjurisdictional companies, does not produce a tax saving to the jurisdictional company nor to the corporate system as a whole. Were the courts below correct that the Commission erred in using the tax effect of such non-jurisdictional losses to reduce the jurisdictional company's rates, when the losses themselves were not borne by the jurisdictional company's costomers.

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[1] In *Cities Service Gas Co.* v. *FPC*, 337 F. 2d 97 (C.A. 10, 1964) and *United Gas Pipe Line Co., et al* v. *FPC*, 357 F. 2d 230 (C.A. 5, 1966).

STATEMENT OF THE CASE.

The decision hereinbelow by the Commission,[2] on the "consolidated tax issue" involved herein, was accomplished by perfunctory reference to the Commission's decision in *Cities Service Gas Co.*, 30 FPC 158 (1963). In both *United*, below, and in *Cities Service*, two of the five Commissioners strongly dissented. The Commission's *Cities Service* decision was reversed by the United States Court of Appeals for the Tenth Circuit, without dissent, opinion by Chief Judge Murrah.[3] The Commission's decision in *United* was reversed below by the United States Court of Appeals for the Fifth Circuit, without dissent, *per curiam*.[4]

United Gas Pipe Line Company (United), whose rates were in issue in the proceedings below before the Commission, is a natural gas pipeline system. United is regulated by the Commission as to about one-half of its operations.

United is a wholly-owned subsidiary of the United Gas Corporation (Corporation), which owns and operates natural gas distribution systems in various areas of Texas, Louisiana and Mississippi. Corporation is also the parent of Union Producing Company (Union), a company engaged in the exploration for and development and operation of both natural gas and oil production properties,

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[2] *United Gas Pipe Line Co.*, 31 FPC 1180 (1964).
[3] 337 F. 2d 97 (C.A. 10, 1964).
[4] 357 F. 2d 230 (C.A. 5, 1966).

and of United Overseas Production Corporation (Overseas), a corporation participating in an oil exploration project in Tunisia, North Africa. Corporation and Overseas are not subject to Commission jurisdiction. None of the oil operations, and only a portion of the gas operations, of Union are subject to Commission jurisdiction.

Together, these corporations (Corporate System) form an affiliated group that joins, for purposes of paying Federal corporate income tax, in a consolidated return filed by the parent, Corporation.

In its rate case before the Commission, involving its rates to its jurisdictional customers, out of which the proceeding below arose, United included as a component of its rates an amount reflecting reimbursement of federal income taxes computed at 52% of anticipated income. Fifty-two percent (52%) was, of course, the actual, lawful statutory tax rate in effect during the test year for the rate case.[5] The Commission, however, relying on its own decision in *Cities Service Gas Co., supra* (subsequently reversed, *Cities Service Gas Co.* v. *FPC*, 337 F. 2d 97 (C.A. 10, 1964)) rejected United's use of the normal public utility computation of a reasonable tax allowance, based on 52% of income. Instead, the Commission computed an allowance for federal income tax, for United's rates, on the basis of what *it decided* was a *proper* tax cost allowance. In essence, the Commission derived a "tax" rate less than the actual statutory rate, by use of a method

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[5] In 1964, the tax rate was reduced to 50% and to 48% for 1965 and thereafter. The rate was 52% in the years relevant to these proceedings, however (subject to surtax adjustment, which is ignored here for simplicity).

of computation which it referred to as reflecting an "effective consolidated tax rate," in arriving at its so-called "actual taxes payable." In fact, however, as will be shown below, United's own income was actually taxed at the statutory 52% rate, and the use of a consolidated tax return also did not result in a tax saving to the corporate system.

Basically, what the Commission did was to require a reduced tax component of United's rates by utilization of tax reductions and tax losses attributable to the unrelated and non-utility operations of affiliated companies, including companies and operations not subject to Commission jurisdiction. No part of the expenses which produced those losses, and no part of the losses themselves, have, of course, been used by the Commission in setting United's rates. Inclusion of such items would increase United's rates. Yet, the Commission has attempted to decrease United's rates by the tax effect of those losses on the system, in one year. The defects in this selective breach of corporate boundaries will be discussed below.

ARGUMENT.

The reasons why the decision of the Court of Appeals, below, need not be reviewed by this Court, will be summarized herein.

At the outset, it should be noted that although the petition herein speaks strongly of the dollar importance of these proceedings, the Solicitor and Commission did not think the matter of sufficient importance to seek review by this Court of the *Cities Service* decision in 1964, even though whatever consequences attach to the decision below were raised first, and in equal measure, in that case.

Further, there is no conflict among the United States Courts of Appeals regarding the question here involved, and neither Petitioner has been able to point out any conflict which this Court must resolve. The Petition on behalf of the Commission cites *El Paso Natural Gas Co.* v. *Federal Power Commission,* 281 F. 2d 567 (C.A. 5, 1960) and seems to indicate that the decision hereinbelow violates the "actual taxes" principle of *El Paso.* Yet, the decision below is by the same Court of Appeals for the Fifth Circuit which decided *El Paso,* and shows recognition of the fact that it is the Commission's decision hereinbelow which violates the "actual taxes" principle.

The short summary of this case is that the Federal Power Commission has violated its jurisdictional authority and has also ignored the actual source and nature of "consolidated tax return savings," all in its zeal to reduce pipeline rates, and has thus produced an illogical, as well as unlawful, result. That result has now been properly corrected by two United States Courts of Appeals.

1. THE COMMISSION'S VIOLATION OF ITS JURISDICTIONAL LIMITS.

The Commission's technique in achieving its "consolidated effective tax rate," as set forth, *inter alia*, in its Petition herein, shows that while the Commission purports to respect its own jurisdictional limits, it actually achieves its predetermined result only by utilizing tax losses of other companies in the Corporate System, which companies are not subject to Commission jurisdiction, to reduce the rates of United, which is subject to Commission jurisdiction. Footnote 8 at page 10 of the Commission's Petition herein makes this clear, when it admits that the Commission's method "may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group."

It is important to note, however, in addition to that damaging (to the Commission) admission, that the Commission's use of the terms "regulated" and "unregulated" is very specialized, and could be misleading. When the Commission's Petition herein states that the Commission's "consolidated effective tax" technique "separated the affiliated corporations into regulated and unregulated groups,"[6] the Commission uses "regulated" to mean regulated by *some* agency, but not necessarily regulated by the Federal Power Commission. Thus, even when dealing within the bounds of its own "regulated" category, the Commission exceeds the limits of its own jurisdiction. This is made clear at 31 FPC 1190-91, where the Commission stated that it had classified United Gas Corporation (the parent of Respondent United herein) as a regu-

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[6] Petition of Commission, p. 7.

lated company because it is partly regulated, in that it "engages in the distribution of gas and its rates are variously subject to regulation *by state commissions and municipalities.*" (emphasis added).

Thus, the method used by the Commission itself has, as its first step, a procedure which ignores the jurisdiction of the Commission itself and deals with an irrelevant category—the category of companies subject to jurisdiction by *someone*. The United States Courts of Appeals which have ruled on the "consolidated effective tax rate" technique have recognized this violation of the jurisdictional limits imposed upon the Commission by the Natural Gas Act,[7] and by the relevant decisions of this Court.[8]

In the earlier *Cities Service* case, the Tenth Circuit recognized this fact, stating:

> "We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually, a legitimate end justifies the means. See: *Colorado Interstate Gas Co.* v. *FPC, supra; Panhandle Eastern Pipe Line Co.* v. *FPC, supra; Wisconsin* v. *FPC,* 373 U.S. 294. . . . But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regu-

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[7] 15 U.S.C. § 717(b).

[8] For example, *Panhandle Eastern Pipe Line Co.* v. *Public Service Commission of Indiana,* 332 U.S. 507, 516 (1947); *FPC* v. *Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, 503 (1949); *Panhandle Eastern Pipe Line Co.* v. *FPC,* 324 U.S. 635, 641-642 (1945); *Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581 (1945).

lated and nonregulated activities for the determination of the ingredients of the rate base." (337 F. 2d at 100-101).

And that Court concluded (337 F. 2d at 101):

> "It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside."

This holding came after FPC Commissioners Woodward and O'Connor stated, in dissent in *Cities Service*, that:

> "[T]he majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; . . ." (30 FPC at 172)

Similarly, in the case below, Commissioners Woodward and O'Connor dissented to the "consolidated effective tax rate" method, and the United States Court of Appeals for the Fifth Circuit reversed, stating (357 F. 2d at 231):

> "• • • We do not think there are any such fact differences between Cities Service and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be vacated and set aside."

In the proceedings below, except for its use of a "consolidated rate" income tax allowance, the Commission stayed within its jurisdictional authority and fixed United's jurisdictional rates solely on the basis of those costs, expenses, and revenues attributable to the jurisdictional business of United. In determining United's jurisdictional cost of service, the Commission quite properly did not include *any* of the costs and expenses of conducting the nonregulated businesses of United's affiliates. However, in devising the "consolidated tax method," the Commission has failed to comply with that jurisdictional requirement.

The Natural Gas Act limits the regulatory authority of the Commission to the transportation and/or sale for resale in interstate commerce of natural gas. The Act gives the Commission no regulatory authority over the local distribution of gas, nor does the Act give the Commission regulatory authority over any aspect of the oil business or over the affairs of a company engaged in overseas exploration for gas and oil. The Courts of Appeals have properly held that the consolidated effective tax rate method of apportionment of the total tax liability among the regulated companies, devised by the Commission in *Cities Service* and used by it in the proceedings below, fails to comply with those jurisdictional requirements.

2. THE "ALLOCATION" CLAIMS OF PETITIONERS.

The Petitions herein, for the Commission and Memphis Light, Gas and Water Division (Memphis), each speak at length about "allocations." The former claims that "the court of appeals did not criticize the particular allocation formula applied by the Commission (see Statement, *supra*, pp. 7-8); it apparently held that the Commission is power-

less to allocate under *any* formula—at least in a case like the present where some of the activities of the consolidated group that give rise to the tax losses are outside the regulatory regime of the Commission." (Petition of Commission, p. 10) And footnote 8, appended to the above passage, recognizes the defects of the Commission method. Memphis, on the other hand, goes on at length defending the particular allocation made by the Commission below.

What both Petitions fail to recognize, or disclose, is that there is a need for the Commission to *allocate* costs *only* when it is not possible to directly *assign* costs. That is to say, if it is clear that cost X is incurred directly by Company Y, or activity Y, it is not necessary, and is inaccurate and inequitable, to allocate a portion of a total cost into which cost X has been artificially placed, instead of assigning cost X, itself, to company Y. It is only a portion of a *joint* cost which must be allocated, because such cost is not separately incurred and, thus, is not directly assignable.

Federal income tax, on the other hand, is not a joint cost. It is incurred separately and directly by each company. A company's federal income tax liability for a given year is directly ascertainable from that company's income tax return. Since that is the case, there is no need to allocate costs—indeed, there is no joint cost to allocate.

Therefore, the Courts of Appeal have been quite correct in concluding that the consolidated tax "allocations" manufactured by the Commission have simply been a device to use tax losses of companies outside the Commission's jurisdiction to reduce the tax allowances of jurisdictional companies, to a level below the actual, separately computed taxes of such jurisdictional companies.

3. THE CLAIMS OF TAX "SAVINGS."

Underlying the Commission's decision in the proceedings below is the basic assumption, made by a bare three to two majority of the Commission in the *Cities Service* case and hereinbelow, that by filing a consolidated return, rather than separate returns, a group of corporate affiliates received an overall tax "saving." In fact, no such "saving" is received. The Commission, however, by holding that its decision in *Cities Service* was controlling below, apparently was convinced that the Corporate System in which United is a subsidiary had received such a "saving" for the test period. Proceeding on that assumption, the Commission apparently reasoned that United should share in this "saving" and that its share should be passed on to its jurisdictional customers in the form of reduced rates.

Both parts of this conclusion are faulty. In the first place, even if it were assumed, contrary to fact, that the use of a consolidated return did cause a tax saving for the Corporate System in which United is a subsidiary, it by no means follows that such saving, even if it existed, should be used to reduce the rates of *United*. The losses which would cause such saving are losses of subsidiaries of the parent company—Corporation. As such, such *losses* were not used to affect the rates of *United*, and properly so. As yet, the Commission would use the tax effect of such losses, and this despite the fact that the parent had more than enough income to "use up" the losses. Plainly, the stockholders of the parent company have financed, borne the costs and expenses, and suffered the losses of the nonregulated business of the loss company subsidiaries. Thus, those stockholders are entitled to the benefit of any tax savings which result from these non-

jurisdictional operations. As Commissioner Woodward said in his dissenting opinion in *Cities Service, supra*:

> "The parent company here owns, directly or indirectly, 100% of the stock of every corporation which participates in the filing of its consolidated return. As such stockholder it owns 100% of the assets of each corporation, and it is entitled to 100% of all net income of each, subject to income tax levies. Also, as the sole stockholder, it bears 100% of every risk, expense and loss sustained by its subsidiaries. These expenses and losses should not be appropriated for the consumers of a regulated natural gas company who bore no part of them, assumed no risks in relation to them, and have no right to use them to reduce their gas costs." 30 FPC at 173.

Thus, the allocation of the loss benefits (assuming allocation is needed and lawful, as it is not) is faulty, because United is not the responsible entity.

The Commission's Petition herein attempts to combat the above fact by claiming (at pp. 11 and 12 thereof) that the corporate group is an integrated, interdependent unit, each part of which is necessary to utilize the tax losses of the entities which are not subject to Commission jurisdiction. Such formulation has several vitiating defects.

a. As noted above, the profits of *United* are not necessary to utilize the losses of the non-jurisdictional loss companies in the system. The parent companies' profits are sufficient to offset such losses and make them useful.

b. As noted above, it is the parent company and its stockholders which take the risks of losses in the non-jurisdictional operations and subsidiaries, so that it is just (as well as jurisdictionally necessary) that they receive any tax offsets which such losses produce.

c. The assumption that a tax "saving" accrues to United itself, and to the Corporate System of which United is a part, by reason of the consolidated tax return filing, overlooks several facts. First, inclusion of United in the return increases the tax of the system by 52% of United's taxable income. Thus, its inclusion caused no "saving" or tax reduction. The Court of Appeals for the Tenth Circuit recognized this principle in *Cities Service*, and it is equally true here:

> "We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52% rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability." 337 F. 2d at 100.

It is also true that United's income was not necessary to "offset," and thus make use of, the losses of the non-jurisdictional companies and operations in the system, because of a factor in addition to the above described fact that the parent company's income is sufficient to offset those losses. That other factor is that the loss company itself could utilize the losses, in other years, by operation of the loss "carryover" and "carryback" provisions of Section 172 of the Internal Revenue Code of 1954, by which losses of one year can be "saved" and used to offset profits of the same company in other years. There is testimony in the record below that Union could generate profits to utilize past losses, if it had been necessary to do so. (R 2863, 3280) Again, "allocation" of such losses to United is unjustified and artificial.

CONCLUSION.

Joint Respondents respectfully submit that the only two United States Courts of Appeals which have considered the question herein, including the Court below, have correctly held that the Federal Power Commission's "consolidated effective tax rate" device utilizes illusory tax "savings" which result from the operations of separate companies which are not subject to Commission jurisdiction, to reduce the rates of United Gas Pipe Line Company, and that such action is in violation of the Commission's jurisdictional authority, violates proper standards for "allocation" and "assignment" of costs, and erroneously distributes cost burdens within the corporate system. The decision of the Court of Appeals below is correct. There is no conflict of Circuits to resolve. The Petitions for writ of certiorari herein should be denied.

Respectfully submitted,

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